**How to Create Effective Formal Credit Institutions Using Informal Institutions: A Case Study of Hawala Regulations in Afghanistan**

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Abstract

Hawala is an ancient system of remittance that originated from South Asia. It has proven to be very adaptive and hence it is still an important part of economic life in less developed countries especially in its birth place of South Asia. Hawala provides a user-friendly, inexpensive, and opaque way to move funds within a dense network of Hawaladars across disparate locals. Hawala was originally used to facilitate long-distance trade. Hawaladars would issue, negotiate, and discount bill of exchange issued in variety of currencies along the famous trade route of Silk Road allowing merchants to safely move funds. More recently, with globalization of labor markets and the concomitant expansion of labor migration (especially from South Asian countries to Gulf Countries) Hawala remittance emerged as the method of choice for migrant works remitting a portion of their income to their families. The opaque operation of Hawala system has also made it attractive to those who wish to move funds covertly to finance terrorist or other illegal activities or launder the proceeds from these illegal activities. Hence, terrorism financing and money laundering are two other globalization phenomena that came to use Hawala remittance system as an integral part of their illegal financial activities.

The Hawala entanglement with illicit funds has caused it to be perceived as an impediment to combating illicit funds. Relatedly, some policymakers attribute the failure of financial inclusion policies, at least in part, to the stickiness of the informal financial systems like Hawala. To counter the precited and real negative roles of Hawaladars in the financial system, regulators have adopted Hawala regulations in different countries. These policies range from complete outlawing of the practice to a series of licensing and transparency-enhancing measures. These policies have often had modest success due to resilient demands for Hawaladars’ services. Furthermore, due to the scarcity of reliable data, full impact of Hawala regulations on the economic life of the Hawala- users is not completely understood. The current Hawala literature reflects the views of countries which are not users of Hawala services rather they are negatively affected by some of Hawaladars’ new users such as terrorist groups and organized crime syndicates. Accordingly, the design of Hawala regulations, advocated for by the international organizations such as Financial Action Task Force (FATF), are eschewed by the views of non-user-countries to prevent the flow of illicit funds to these countries. As a result, hawala regulations often fail to fully consider the context of use of Hawala, the way Hawala interacts with the local economy, and the potentials for indigenous, bottom-up regulatory framework for countering the ills of Hawala markets. This article, drawing on extensive field research in Afghanistan, studies the recent failed attempt by Da Afghanistan Bank (Afghanistan’s Central Bank) to regulate the Hawala markets in Afghanistan to illustrate the shortcomings of the current approach to regulation of Hawala markets, and how countries like Afghanistan can create more effective policies using a bottom-up approach.